

Attribution of Stock Ownership from Stock Options Under the Internal Revenue Code

The distribution of stock ownership is important for determining the application of many substantive provisions of the Internal Revenue Code. For example, certain tax provisions apply only if the number of shareholders does not exceed a set maximum¹ or if particular shareholders own a specified minimum percentage of stock.² In determining whether an individual owns stock, the tax law often considers beneficial as well as legal ownership. Stock ownership may be attributed to a party under a judicial or statutory presumption that the party controls or derives benefit from the stock.³

This comment analyzes the Code's treatment of whether the holder of a stock option⁴ should be treated as owning the stock

¹ For example, a corporation generally can qualify as a Subchapter S corporation only if it has ten or fewer shareholders. I.R.C. §§ 1371-1379; see text and notes at notes 33-36 *infra*. Similarly, a corporation may be subject to the 70% personal holding company tax only if five or fewer shareholders own more than 50% of the stock. I.R.C. § 542(a)(2); see text and notes at notes 57-58 *infra*.

² For example, the transfer of property to a corporation in return for its stock or securities is not taxed if the transferor owns 80% of the corporation's stock after the transfer. I.R.C. § 351(a); see text and notes at notes 19-21 *infra*.

³ Under some provisions, an irrebuttable presumption of control or benefit applies to stock owned by various family members, treating an individual as owning the stock owned by members of his family. See, e.g., I.R.C. §§ 267(c)(2), (4), 318(a)(1), 544(a)(2), 1563(e)(6). The presumption also applies to stock owned by corporations, partnerships, trusts, and estates in which a party has an interest. See, e.g., I.R.C. §§ 267(c)(1), 318(a)(2), 544(a)(1), 1563(e)(2)-(4), 4943(d)(1).

⁴ Neither the Code nor the regulations define the term "stock option." The best guidance is found in a revenue ruling that defines options for the purpose of applying the constructive ownership rules of § 318 to a stock redemption. Rev. Rul. 601, 1968-2 C.B. 124. Under this ruling an option exists only if the holder has the right to obtain the underlying stock at his election and if the election is not subject to any contingencies. Prior to this ruling commentators had expressed concern that defining options to include a buy-sell agreement, which typically becomes operative only upon death, retirement, or other future events, would create tax consequences differing greatly from those expected by the parties. See, e.g., Goldstein, *Attribution Rules: Undue Multiplicity, Complexity Can Create Liabilities*, 15 TUL. TAX INST. 384 (1965); Ringle, Surrey & Warren, *Attribution of Stock Ownership in the Internal Revenue Code*, 72 HARV. L. REV. 209 (1958). This ruling assuages these concerns by excluding contingent purchase arrangements from the definition of option. A set of attribution rules proposed by the ABA's Section on Taxation also excludes a buy-sell agreement from option attribution by requiring attribution from options only where no substantial contingencies beyond the control of the grantee exist. See Comm. on Affiliated & Related Corps., *Committee Recommendations*, 21 TAX LAW. 921 (1968) [hereinafter cited as ABA Proposed Attribution Rules]; note 8 *infra*.

A stock option can therefore be defined as a unilateral right to acquire stock at the election of the optionholder. An option may or may not have an expiration date and typically requires the holder to provide additional consideration for the stock.

underlying the option for purposes of applying various tax provisions. The current law governing the attribution of stock ownership from options has been criticized as inconsistent.⁵ Some provisions treat the optionholder as owning the underlying stock;⁶ others have no stated rules,⁷ leaving the issue to be decided case by case. A uniform treatment of attribution to optionholders,⁸ however, would be inappropriate because attribution rules must accommodate the differing purposes of the various Code provisions.

This comment examines the treatment of optionholders under illustrative Code sections⁹ and evaluates the relevant attribution rules in light of the purposes of those sections. In the first provisions considered, attribution to optionholders is neither provided for nor appropriate. This category includes sections dealing with corporate organization¹⁰ and reorganization,¹¹ Subchapter S corporations,¹² and consolidated returns.¹³ Next, those sections presently requiring excessive attribution are examined. They include the provisions

⁵ See, e.g., Hawkins, *Treatment of Stock Options for Attribution Purposes: Unsatisfactory and Inconsistent*, 44 J. Tax 80 (1976); Reilly, *An Approach to the Simplification and Standardization of the Concepts "The Family," "Related Parties," "Control," and "Attribution of Ownership,"* 15 Tax L. Rev. 253 (1960); Ringel, Surrey & Warren, *supra* note 4.

⁶ See, e.g., I.R.C. §§ 318(a)(4), 544(a)(3), 1563(e)(1).

⁷ See, e.g., I.R.C. §§ 267(c), 368(c), 1371, 1504, 4943(d).

⁸ The ABA Proposed Attribution Rules provide:

Options.—If any person has an option to acquire stock, such stock shall be considered as being owned by such person. For purposes of this paragraph,—

(A) an option will not result in attribution if it is not exercisable within 3 years of the date of determination of constructive stock ownership, if on such date it is subject to substantial contingencies beyond the control of the optionee, or if on such date the option price exceeds 150 percent of the fair market value of the stock subject to such option;

(B) an option to acquire an option, and each one of a series of such options, shall be considered as an option to acquire such stock; and

(C) in determining the percentage stock ownership of an optionee of stock which is not issued and outstanding, such stock shall be considered as issued and outstanding.

ABA Proposed Attribution Rules, *supra* note 4, at 923.

⁹ The holding period and the basis of the stock underlying options, although related to the ownership of stock underlying options, will not be discussed. The dispute concerning treatment of options on unissued stock has been discussed elsewhere and will not be explored here. See *Sorem v. Commissioner*, 334 F.2d 275 (10th Cir. 1964); *Bloch v. United States*, 261 F. Supp. 597 (S.D. Tex. 1966), *aff'd per curiam*, 386 F.2d 839 (5th Cir. 1967); Rev. Rul. 601, 1968-2 C.B. 124; Hawkins, *supra* note 5. See also ABA Proposed Attribution Rules, *supra* note 4, at 923. The provisions discussed in this comment were selected to exemplify the types of problems concerning stock ownership attribution found throughout the Internal Revenue Code.

¹⁰ I.R.C. § 351.

¹¹ I.R.C. § 368.

¹² I.R.C. § 1371.

¹³ I.R.C. § 1504.

dealing with personal holding companies,¹⁴ stock redemptions,¹⁵ and controlled corporations.¹⁶ These sections sweep too broadly in failing to distinguish between abusive and nonabusive transactions; attribution rules having a less restrictive effect are recommended. The final sections discussed presently provide for inadequate option attribution. Specifically, the provisions dealing with the excess business holdings tax¹⁷ and the denial of loss recognition on sales between related parties¹⁸ do not provide for option attribution. Since the omission of an attribution requirement from these provisions permits some abusive transactions to escape appropriate tax treatment, needed attribution rules are suggested.

I. NO ATTRIBUTION TO THE OPTIONHOLDER REQUIRED

A. Corporate Organization and Reorganization

The concept of control makes stock ownership pertinent to the corporate organization and reorganization sections of the Code.¹⁹ Certain transactions are nontaxable only if specified parties are "in control" at the conclusion of the transaction. For example, the transfer of property to a corporation in return for the stock or securities of that corporation is a nontaxable event if after the exchange those who transferred the property are in control of the corporation.²⁰ Control is statutorily defined as the ownership of at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock.²¹

Although the Code is silent on the question, the courts have established a general rule that, for the corporate organization and reorganization provisions, an optionholder does not own the stock underlying his option.²² The courts reason that an optionholder's

¹⁴ I.R.C. § 544.

¹⁵ I.R.C. § 302.

¹⁶ I.R.C. § 1563.

¹⁷ I.R.C. § 4943.

¹⁸ I.R.C. § 267.

¹⁹ I.R.C. §§ 351, 368.

²⁰ I.R.C. § 351(a). Control is also critical to qualifying under the reorganization provisions of §§ 368(a)(1)(B), (D).

²¹ I.R.C. § 368(c).

²² *Helvering v. Southwest Consol. Corp.*, 315 U.S. 194 (1941); *Commissioner v. National Bellas Hess, Inc.*, 200 F.2d 415 (8th Cir. 1955); *Herman Berghash*, 43 T.C. 743 (1965), *aff'd*, 361 F.2d 257 (2d Cir. 1966); *American Wire Fabrics*, 16 T.C. 607 (1951); *Robert J. Harder*, 17 T.C.M. (CCH) 494 (1958). *But cf. Barker v. United States*, 200 F.2d 223 (9th Cir. 1952) (option grantor not treated as controlling underlying shares because option agreement deprived grantor of unrestricted control of stock).

rights differ significantly from those of a shareholder. An optionholder has no vote and thus no direct voice in the corporation's affairs, has no right to receive dividends or otherwise share in the corporation's earnings, and would receive nothing if the corporation were to liquidate. The bundle of rights possessed by the optionholder is thus unlikely to give him the requisite control over the newly formed or reorganized corporation.²³ Furthermore, the likelihood that the optionholder will acquire the rights of a shareholder and thus acquire control is uncertain. The optionholder may have to supply additional consideration or act within a specified time and may choose not to exercise the option.

The general rule of nonattribution is consistent with the control criterion of the corporate organization and reorganization provisions.²⁴ Although the rule can be abused, the courts have invoked the step-transaction doctrine²⁵ to remedy such abuses, thereby eliminating the need to modify the general rule of nonattribution to prevent tax avoidance schemes. Under the step-transaction doctrine, the separate steps of a transaction are viewed as an integrated whole to determine the tax consequences. The doctrine's operation is illustrated in *Ericsson Screw Machine Products Co.*²⁶ In this case, A corporation and B corporation contributed assets to C corporation in return for all of C's stock. A and B hoped that the transaction would qualify as a tax-free reorganization,²⁷ in order to preserve the high basis of B's assets.²⁸ As part of the plan, B granted an option to A to purchase the C stock received by B. A exercised the option

²³ The most significant similarity between an optionholder and a stockholder is that the value of their holdings is a direct function of the price of the stock.

²⁴ See text and notes at notes 30-32 *infra*.

²⁵ The essence of the step-transaction doctrine is that an integrated transaction may not be broken into independent steps or, conversely, that the separate steps must be taken together in determining the tax consequences. See *King Enterprises, Inc. v. United States*, 418 F.2d 511 (Ct. Cl. 1969), citing B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* § 1.05 (2d ed. 1966); Mintz & Plumb, *Step Transactions in Corporate Reorganizations*, 12 N.Y.U. INST. ON FED. TAX. 247 (1954); Hobbett, *Step Transaction Doctrine and Its Effect on Corporate Transactions*, 19 TUL. TAX INST. 102 (1970).

²⁶ 14 T.C. 757 (1950).

²⁷ A reorganization that is merely a business readjustment and results in no substantial change in the rights and relations of the interested parties to one another or the assets involved is not a taxable event. See text and notes at notes 30-31 *infra*.

The parties in *Ericsson* were trying to satisfy Int. Rev. Code of 1939, ch. 247, § 112(g)(1)(a), 53 Stat. 47 (now I.R.C. § 368(a)(1)(D)), which provided that a transfer by a corporation of all or part of its assets to another corporation is a reorganization and therefore not a taxable event if immediately after the transfer the transferor or its shareholders, or both, are in control of the transferee corporation.

²⁸ The basis of property transferred pursuant to a tax-free reorganization is generally carried over from the transferor to the transferee. I.R.C. § 362(b).

six months after the formation of *C*, paying the fair market value of the assets contributed by *B*. *A* thus became the sole shareholder of *C*. The Tax Court applied step-transaction analysis to these facts and held that *A* should be treated as owning the stock underlying its option.

The term of the option which set the exercise price at the fair market value of the assets contributed by *B* was a particularly suspicious indication that the substance of the transactions was a sale of *B*'s assets to *C* rather than a corporate reorganization. The parties never intended *B* to keep the *C* stock; *B*'s ownership was merely a transitory step in the overall plan. The option served as the means for ostensibly fulfilling the statutory requirements while allowing *A* to obtain full control of *C*. The court treated the transaction in accordance with its economic substance, finding that the assets had a basis to *C* equal to the amount paid for them, *i.e.*, their fair market value.²⁹

The general rule of nonattribution to an optionholder, in combination with step-transaction analysis, results in favorable treatment under the corporate organization and reorganization provisions for those transactions that Congress intended to benefit. The provisions are designed to allow business readjustments to take place without

²⁹ In some instances, the goal of the parties may be to avoid the corporate organization or reorganization provision, where, for example, there is no gain to recognize and the parties want a stepped-up basis for the assets. *American Bantam Car Co.*, 11 T.C. 397 (1948), *aff'd*, 177 F.2d 513 (3d Cir. 1948). In such situations, options could be used to prevent the transaction from being classified as a tax-free corporate organization. A corporate organization could avoid I.R.C. § 351 if the transferor did not own 80% of the corporation's stock after the transfer. The transferor could receive 79% of the newly organized corporation's stock, the remaining 21% going to a third party (*X*) who grants an option on the stock to the transferor. However, since *X* did not contribute assets to the newly formed corporation, his receipt of the 21% interest may, pursuant to Treas. Reg. § 1.351-1(b)(1) (1955), subject the transferor to gift tax liability because he has in effect made a gift to *X* of the 21% interest. An alternative characterization is that the transferor is compensating *X* by giving him the 21% interest. Treas. Reg. § 1.351-1(b)(1) (1955) also states that under such circumstances *X* would recognize income on the receipt of the stock. This treatment is a significant disincentive to the use of options to avoid I.R.C. § 351. Moreover, the subsequent exercise of the option, which is inevitable if the transferor has not made a gift or given the stock as compensation to *X*, provides appropriate facts for applying the step-transaction doctrine.

Options could be used to avoid satisfying the 80% control requirement for nontaxable reorganizations in the same manner as discussed for corporate organizations. I.R.C. § 368 has no equivalent to Treas. Reg. § 1.351-1(b)(1) (1955), but the gift or compensation characterization seems equally applicable. The principal method for preventing the misuse of options to avoid reorganization treatment is step-transaction analysis. The courts are as willing to apply step-transaction analysis to efforts to avoid reorganization treatment as they are to attempts to qualify as a reorganization. *See Turner Constr. Co. v. United States*, 364 F.2d 525 (2d Cir. 1966); *AFC-Brill Motors Co. v. Commissioner*, 189 F.2d 704 (3d Cir.), *cert. denied*, 342 U.S. 886 (1951).

incurring a tax,³⁰ on the theory that gain or loss should not be recognized on changes of corporate form involving no substantial change in the relationships of the interested parties to one another or in the rights to the assets involved.³¹ Any corporate organization or reorganization will, however, cause some change in the rights and relations of the parties. For example, a group of individuals contributes property to a corporation and receives in return all the corporation's stock. Each member of the group exchanges control over his individual assets for a proportionate interest in the whole of the corporation's assets. As a stockholder, the transferor cannot deal with the corporation's assets in the same manner as when he owned them directly. Nevertheless, Congress decided that the change involved in those transactions that satisfy the corporate organization and reorganization provisions is not substantial enough to treat the transaction as a taxable event.

The changes in the parties' rights and relationships are much more substantial when options are used. The individual who contributes property to a corporation in return for a stock option acquires no definite interest in the corporation's assets, but only the right to purchase stock that would in turn give him the rights of a shareholder. Such an individual has significantly changed his rights to the assets involved. This substantial change makes it inappropriate to include the stock underlying the option as part of the 80% stock ownership necessary to have control. The courts, perceiving the different rights of a shareholder and an optionholder and recognizing Congress's intent to exempt only business readjustments from taxation, have not treated optionholders as owning the stock underlying their option.³² This rule may allow taxpayers, such as the parties in *Ericsson*, to use options to arrange a transaction that is not a business readjustment yet fits within the express language of the corporate organization and reorganization sections, but the step-transaction doctrine prevents the general rule on options from being misused. The courts have thus developed a general rule con-

³⁰ H.R. REP. NO. 350, 67th Cong., 1st Sess. (1921), *reprinted in* 1939-1 C.B. pt.2, at 168, 175; S. REP. NO. 276, 67th Cong., 1st Sess. (1921), *reprinted in* 1939-1 C.B. pt.2, at 181, 188; H.R. REP. NO. 179, 68th Cong., 1st Sess. (1924), *reprinted in* 1939-1 C.B. pt.2, at 241, 151. The law was a reaction against a series of Supreme Court decisions that treated even the slightest business adjustment as a taxable event. *Marr v. United States*, 268 U.S. 536 (1925); *Cullinan v. Walker*, 262 U.S. 134 (1923); *United States v. Phellis*, 257 U.S. 156 (1921); *Rockefeller v. United States*, 257 U.S. 176 (1921).

³¹ B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* § 14.01 (3d ed. 1971).

³² See note 22 *supra*.

sistent with Congress's intent, while avoiding the rule in those situations where it leads to abuse.

B. Subchapter S Corporations

Subchapter S of the Internal Revenue Code³³ allows shareholders of eligible corporations to choose to be taxed as though the corporation was a partnership.³⁴ Stock ownership is relevant to Subchapter S in two ways. To be eligible for treatment under the provisions, a corporation generally cannot have more than ten shareholders,³⁵ and all shareholders must consent to Subchapter S treatment.³⁶

The Subchapter S regulations define a shareholder as one who must include in his gross income dividends distributed with respect to the corporation's stock.³⁷ An optionholder does not include in gross income dividends on the stock underlying his option³⁸ and should not be regarded as a shareholder for the purposes of Subchapter S. The Internal Revenue Service implicitly accepted this conclusion in ruling that the issuance of options will not affect a corporation's eligibility for Subchapter S treatment.³⁹ Not attributing the underlying stock to the optionholder is consistent with the general differences between an optionholder's and a shareholder's rights and with the specific purposes of Subchapter S.⁴⁰

Subchapter S was enacted to enable taxpayers to choose among different forms of business organization without having to take the different tax consequences into account.⁴¹ This purpose is not served

³³ I.R.C. §§ 1371-1379.

³⁴ BITTNER & EUSTICE, *supra* note 31, § 6.01. Subchapter S provides that a corporation's income and losses are not taxed to the corporation but are passed through to the shareholders. I.R.C. §§ 1373-1374.

³⁵ I.R.C. § 1351(a)(1). The Tax Reform Act of 1976, Pub. L. No. 94-455, § 902(a)(2), 90 Stat. 1608, modified the ten shareholder rule by allowing certain qualified corporations to have fifteen shareholders if the corporation has been a Subchapter S corporation for five consecutive years or if the increase in the number of shareholders is due to the acquisition of stock through inheritance. I.R.C. § 1371(e). For an explanation of the changes to the ten shareholder requirement, see Allsworth, *Subchapter S Corporations and The Tax Reform Act of 1976*, PRAC. LAW., Dec. 1976, at 37.

³⁶ I.R.C. § 1372(a).

³⁷ Treas. Reg. § 1.1371-1(d)(1) (1959).

³⁸ Rev. Rul. 234, 1958-1 C.B. 279.

³⁹ Rev. Rul. 269, 1967-2 C.B. 298.

⁴⁰ By focusing on those parties who have beneficial ownership of stock, this analysis is consistent with the approach taken by the courts in deciding who is a shareholder for the purposes of Subchapter S. See, e.g., *Kean v. Commissioner*, 469 F.2d 1183 (9th Cir. 1972); *Pacific Coast Music Jobbers, Inc. v. Commissioner*, 457 F.2d 1165 (5th Cir. 1972); *Alfred Hoffman*, 47 T.C. 218 (1966), *aff'd per curiam*, 391 F.2d 930 (5th Cir. 1968); *Wilson v. Commissioner*, 34 T.C.M. (CCH) 463 (1975).

⁴¹ S. REP. No. 1983, 85th Cong., 2d Sess. (1958), *reprinted in* 1958-3 C.B. 922, 953.

by requiring optionholders to consent to Subchapter S treatment, since the benefits of such treatment depend upon the relative tax brackets of the corporation and the shareholders. The optionholder, who is taxed on neither the dividends nor the income passed through under Subchapter S, has no significant interest in how the corporation's income is taxed. Accordingly, his consent should not be required.⁴²

Exempting optionholders from the determination of the number of shareholders can, however, lead to abuses of Subchapter S. Options can be used to avoid the ten-shareholder limit on a corporation's eligibility. For example, if a corporation has eleven shareholders, the eleventh could sell his stock to the tenth shareholder and receive a repurchase option on the shares.⁴³ But such abuses are not of sufficient likelihood or magnitude to warrant treating all optionholders as shareholders for determining Subchapter S eligibility. Taxpayers are unlikely to engage in abusive option arrangements because the consequence of stock ownership under Subchapter S is that income and losses are passed through to the shareholders.⁴⁴ If the tenth shareholder owns the eleventh stockholder's shares, he will pay the tax on the income attributable to the ownership interest in those shares. This burden is a strong disincentive for such transactions.⁴⁵ Conversely, if the corporation is in a loss position, shareholder eleven would like those losses passed through to him rather than allowing shareholder ten to receive the benefit. Treating optionholders as not owning the underlying stock thus seems appropriate in light of the purposes of Subchapter S and the limited possibilities for abuse.

⁴² This reasoning was applied in *Alfred Hoffman*, 47 T.C. 218 (1966), *aff'd per curiam*, 391 F.2d 930 (5th Cir. 1968), where the court held that a creditor for whom stock was held in escrow as security for a debt was not a shareholder and that his consent to the Subchapter S election was therefore not needed.

⁴³ If the option is exercised shortly after the transfer, suggesting that the parties intended to qualify only temporarily as a Subchapter S corporation, the step-transaction doctrine may be invoked. In addition, if the terms of the option are nominal, the courts may regard the grantor as a nominee and ignore the sale. For the rule that nominees are to be ignored in the Subchapter S context, see *Wilson v. Commissioner*, 34 T.C.M. (CCH) 463 (1975); Rev. Rul. 615, 1970-2 C.B. 169. For the rule that the grantor of an option with a nominal price is merely a nominee and not the beneficial owner, see Rev. Rul. 469, 1970-2 C.B. 179; Rev. Rul. 458, 1955-2 C.B. 579.

⁴⁴ I.R.C. §§ 1373-1374.

⁴⁵ Two parties might attempt to solve this problem by making the exercise price adjustable so that it would be increased by the amount of tax the grantor had to pay on the income attributed to him from the shares subject to the option. However, such an arrangement would so complicate the transaction that the parties are unlikely to resort to it. Moreover, an adjustable exercise price would justify application of the step-transaction doctrine. In *Ericsson Screw Machine Products Co.*, 14 T.C. 757 (1950), a suspicious exercise price was one of the grounds on which the court rested its step-transaction analysis.

C. Consolidated Returns

Before two corporations may file a consolidated income tax return, one must own stock with at least 80% of the voting power of all classes of stock and at least 80% of each class of nonvoting stock of the other corporation.⁴⁶ For the purpose of satisfying the 80% ownership tests, an optionholder is treated as not owning the stock underlying his option.⁴⁷ For example, the Service allows a parent corporation that owns 80% of a subsidiary corporation's stock to include the subsidiary in a consolidated return even though sufficient options are outstanding to dilute the parent's ownership to below 80% if the options were exercised.⁴⁸ Again, this approach is based on the recognition that an unexercised option does not bestow any of the rights or liabilities of stockholders upon the optionholders.

The primary purpose of the consolidated return provisions is to allow a group of corporations comprising an economic unit to be taxed as unit.⁴⁹ Nonattribution from stock options is appropriate in light of this purpose. A corporation holding an option to acquire stock is in a very different position than a corporation owning the stock. The corporate optionholder (*X*) is not likely to shift income, deductions, or credits from itself to the corporation (*Y*) whose stock underlies the option. Because *X* has no assurance that it will receive the benefits of the gains resulting from the shifting of income, *X* is more likely to deal with *Y* at arm's length. Corporations dealing with each other at arm's length will each pursue their own self-interest and should not be taxed as if they were a single economic unit.

Moreover, the possibilities for abusing this rule of nonattribution are slight. The consolidated return provisions are permissive; a parent corporation satisfying the 80% ownership test is not required to file consolidated returns. No incentive exists to manipulate options to avoid the 80% test. Abuse could result, however, if *A* corporation possessed a tax benefit, such as a net operating loss, that it could not use but that *B* corporation could use. The parties might find it advantageous for *B* to acquire *A* stock in order to file

⁴⁶ I.R.C. §§ 1501, 1504(a).

⁴⁷ *Moore v. McGraw*, 63 F.2d 593 (5th Cir. 1933); *Thomas Bayard*, 38 B.T.A. 778, 793 (1938); *Island Petroleum Co.*, 17 B.T.A. 1 (1929), *aff'd*, 57 F.2d 992 (4th Cir.), *cert. denied*, 287 U.S. 646 (1932); *Bay State Sec. Co.*, 3 B.T.A. 43 (1925).

⁴⁸ Rev. Rul. 251, 1964-2 C.B. 338.

⁴⁹ F. PEEL, CONSOLIDATED TAX RETURNS 33 (1973); S. REP. NO. 617, 65th Cong., 3d Sess. (1918), 1939-1 pt. 2 C.B. 117, 123.

consolidated returns if *B* could give the *A* shareholders an option to repurchase with the intent that the option be exercised once the tax benefit is used.⁵⁰ Option attribution is not necessary to remedy this abuse. Instead, section 269, giving the government authority to disallow a deduction or credit when the principal purpose of an acquisition is to obtain a deduction or credit to which the taxpayer is otherwise not entitled, should be sufficient to handle abusive transactions.⁵¹ Furthermore, a transfer of stock with an option granted to the transferor, followed by an exercise of the option, invites the application of step-transaction analysis. Finally, if the tax benefit is a net operating loss, section 382 will come into play and disallow all or part of the loss.⁵² With the IRS and the courts armed with sections 269 and 382 and the step-transaction doctrine, the possibilities for abuse do not seem significant enough to require a change in the general rule.

II. EXCESSIVE ATTRIBUTION TO THE OPTIONHOLDER

A. Personal Holding Company

The first statutory requirement that an optionholder should be treated as owning the stock underlying the option appeared in 1937 as an amendment to the personal holding company provisions.⁵³ These provisions had been adopted in 1934 to prevent a relatively simple tax avoidance scheme: an individual forms a corporation and exchanges his personal holdings in stocks, bonds, or other income-producing property for the corporation's stock; the income from these properties is taxed to the corporation, but the individual pays no tax if the income is not distributed.⁵⁴ The personal holding company resulted in substantial tax savings for an individual whose marginal tax rate was higher than the corporate rate.⁵⁵ The 1934

⁵⁰ The exercise price would be set to compensate the *A* shareholders for the tax benefit used by *B*.

⁵¹ Typical applications of I.R.C. § 269 are *PEPI, Inc. v. Commissioner*, 448 F.2d 141 (2d Cir. 1971); *Scroll, Inc. v. Commissioner*, 447 F.2d 612 (5th Cir. 1971); *Swiss Colony, Inc. v. Commissioner*, 428 F.2d 49 (7th Cir. 1970).

⁵² I.R.C. § 382, as amended by the Tax Reform Act of 1976, contains a detailed set of rules for disallowing net operating loss carryovers of corporations acquired by purchase or reorganization. For an explanation of the significant changes made to I.R.C. § 382 by the 1976 Act, see Libin, *Recent Developments in Corporate Organizations and Reorganizations—Including a New Look for Sec. 382*, 54 TAXES 876 (1976).

⁵³ Revenue Act of 1937, ch. 815, § 354(a)(3), 50 Stat. 815 (codified as I.R.C. § 544(a)(3)).

⁵⁴ One of the government's weapons for preventing this scheme, a penalty tax on unreasonable accumulations of income, functioned poorly because of the difficulty of proving that a holding company's accumulated income was unreasonable.

⁵⁵ H.R. REP. No. 704, 73d Cong., 2d Sess. (1934), reprinted in 1939-1 C.B. pt. 2, at 554, 562.

provisions removed the advantage from this scheme by imposing a surtax on the undistributed income of companies that fall within the statutory definition of a personal holding company.⁵⁶

One of the statutory tests for a personal holding company is that five or fewer individuals own more than 50% of the value of the stock.⁵⁷ The first personal holding company provisions included rules governing attribution of ownership⁵⁸ that were designed to give meaning to the statutory phrase "owned directly or indirectly, by or for not more than five individuals." The rules provided that, for purposes of the 50% ownership test, an individual constructively owns the stock owned by various members of his family and by a corporation, partnership, estate, or trust, in proportion to his interest therein.⁵⁹

These constructive ownership rules did not prevent taxpayers from easily avoiding the 50% ownership test through the use of options.⁶⁰ For example, five shareholders owning shares representing 51% of the value of the company would transfer 2% of the value of the shares to a friendly outside party, subject to an option to repurchase the shares. Congress, viewing such shareholders as "for all practical purposes in the same situation as if they owned 51 per cent in value of the stock,"⁶¹ expanded the definition of constructive stock ownership to treat the holder of an option to acquire stock as owning the stock underlying the option.⁶²

This provision has the advantage of providing a clear and simple test and has consequently engendered little litigation.⁶³ How-

⁵⁶ I.R.C. § 542 defines a personal holding company in terms of the nature of its income and the concentration of the ownership of its stock.

⁵⁷ I.R.C. § 542(a)(2). The test requiring that more than 50% of the value of the stock be owned by five or fewer shareholders will hereafter be referred to as the 50% ownership test.

⁵⁸ These constructive ownership rules are now part of I.R.C. § 544. These rules are also used for the foreign personal holding company provisions in I.R.C. §§ 551-558. Because the analysis of stock ownership for personal holding companies is equally applicable to foreign personal holding companies, they are not discussed separately.

The constructive ownership rules operate only where their effect is to make the entity a personal holding company. Thus an actual owner's interest is not reduced if another party constructively owns the stock. *See* I.R.C. § 544(a)(4)(A).

⁵⁹ Attribution from corporations, partnerships, estates, or trusts will hereafter be referred to as "interested entity attribution."

⁶⁰ This problem is the opposite of that found in Subchapter S. There the taxpayer's goal is to have the number of shareholders fall below the statutory ceiling; here the taxpayer's goal is to have the number of shareholders exceed the statutory floor.

⁶¹ H.R. REP. No. 1546, 75th Cong., 1st Sess. (1937), *reprinted in* 1939-1 C.B. pt. 2, at 704, 709.

⁶² I.R.C. § 544(a)(3). I.R.C. § 555(a)(3) is the equivalent rule under the foreign personal holding company provisions.

⁶³ The only reported cases involving options under the personal holding company provisions are *Estate of Nellie S. Miller*, 43 T.C. 760 (1965), and *Foremeno Ltd.*, 3 T.C.M. (CCH) 981 (1944).

ever, the section is broader than the tax-avoidance abuses it seeks to remedy; unwary persons can unintentionally become entangled in the personal holding company provisions.⁶⁴ An example illustrates this overbreadth. A corporation with twenty shareholders arranges for its officers, who are already shareholders, to have options to purchase some of the stock of the other shareholders. The exercise price is set to reward the officers if the company prospers. If the officers number five or less and their current stock holdings added to their optioned shares exceed 50% of the value of the corporation's stock, the corporation meets the stock ownership test for personal holding companies and is subject to the possibility of taxation under the provisions despite the absence of any tax avoidance motive.⁶⁵

An appropriate rule for attributing stock ownership to optionholders under the personal holding company provisions must satisfy several criteria. Because options do provide a means to avoid the provisions, a prophylactic rule is required. The rule should be broad enough to prevent such avoidance, yet sufficiently narrow so as not to affect option arrangements not intended to avoid the tax on personal holding companies.

Viewed from this perspective, the current option attribution rules are more difficult to justify than the family and interested entity (corporation, partnership, trust, or estate) attribution rules. An individual indirectly benefits from the stock owned by his family or an entity in which he has an interest, and it is reasonable to assume that he controls such stock. The Code appropriately treats one benefiting from stock and having control over it as its owner. The presumptions of control and indirect benefits that apply to family and interested entity situations are not directly transferable to options, however. A rule attributing ownership from options must distinguish between situations in which the optionholder should be presumed to control and derive benefits from the underlying stock and situations in which no such presumption arises.⁶⁶ Option attribution is justified only in the former situation, where the grantor of

⁶⁴ This possibility is reduced by the fact that stock ownership is not the only test for personal holding company status. An income test requirement, I.R.C. § 542(a)(1), must also be satisfied before the personal holding company tax is imposed. Stockholder status is relevant for the income test provisions as well. See I.R.C. § 544(a)(4).

⁶⁵ Although this situation might be avoided by appropriate planning, the burden for tax planning by unsuspecting individuals is unnecessary to the statutory purpose. A better approach is to redraft the statute to narrow the attribution rule.

⁶⁶ The rights of an optionholder are generally not by themselves sufficient to create a presumption of control over or benefit from the grantor's stock. See text and notes at notes 22-23 *supra*.

the option can be said to be subordinate to the optionholder.⁶⁷ If the grantor acquired the stock in a transaction initiated by the optionholder, the grantor's independence is questionable. Conversely, if the optionholder was not the moving party in the transaction, the grantor will presumably vote the stock according to his own interests rather than at the direction of the optionholder, and the optionholder is unlikely to benefit from the stock.

The following rules are suggested to replace the option attribution rules currently employed in the personal holding company provisions. The rules are an attempt to require option attribution only in situations in which there is a basis for presuming that the optionholder controls the grantor and thus the grantor's stock.

An optionholder will *not* be regarded as owning the stock underlying his option unless:

(Rule 1) The grantor of the option acquired either the stock subject to the option or the funds to acquire the stock subject to the option directly or indirectly from the optionholder, a member of the optionholder's family,⁶⁸ or an interested entity;⁶⁹ or

(Rule 2) The grantor of the option received his stock

⁶⁷ Options granted by various family members or by an interested entity are of no concern here because the stock on which the option was granted could be attributed to the optionholder through existing family or entity attribution rules. However, current law provides that in a choice between applying the family attribution and the option attribution rules, the option rules will govern. I.R.C. § 544(a)(6). This provision is intended to limit the bar on double family-partnership attribution imposed by I.R.C. § 544(a)(5). If the option rules did not override, for example, the stock underlying an option granted to a wife by her brother would not be attributed to her husband because of the bar on double use of the family-partnership attribution rules.

The bar on double family-partnership attribution is based on Congress's belief that the link between the actual owner and the one made a constructive owner through double attribution is indirect and attenuated. However, since Congress views option ownership in this context as equivalent to actual ownership, the second link is not tenuous and reattribution is therefore proper. See H.R. REP. NO. 1546, 75th Cong., 1st Sess. (1937), reprinted in 1939-1 C.B. pt. 2, at 704, 709.

⁶⁸ "Family" is a technical term defined differently from section to section. See Reilly, *supra* note 5; Ricketts, *An Outline of The Four Major Attribution Rules; How They Operate*, 26 J. TAX 26 (1967). For the purpose of applying Rule 1 to the personal holding company provisions, family is to be defined as provided by the constructive ownership rules of the personal holding company provisions. I.R.C. § 544(a)(2) defines family as including brothers and sisters (whether whole or half blood), spouse, ancestors, and lineal descendants. When Rule 1 is applied to other provisions, the definition of family will be the one used for that provision.

⁶⁹ The definition of interested entity also varies throughout the Code. The interested entities included within the constructive ownership rules of the personal holding company provisions are corporations, partnerships, estates, and trusts. When Rule 1 is applied in other contexts, interested entity will be defined in accord with the definition used in that context.

directly or indirectly from the issuing corporation without supplying consideration equal to the fair market value of the stock.⁷⁰

Rule 1 will cover most situations in which the optionholder can justifiably be presumed to control the grantor. For example, the rule would preclude avoidance of the personal holding company provisions by arrangements in which an optionholder receives stock from the issuing corporation and sells it to the grantor, who then grants an option back to the seller. The language "directly or indirectly" is intended to invite the courts to apply step-transaction analysis and to look to beneficial ownership in order to strike down any arrangement that manipulates stock ownership to avoid the rule's express language. The "funds" language is designed to cover situations in which an optionholder or one acting on his behalf transfers to the grantor the funds to acquire the stock rather than the stock itself. Such a transfer does not diminish the presumption that the optionholder controls the grantor.

The reach of Rule 2 is narrower. It operates to prevent the optionholder from directing the corporation to give stock to the grantor, then arranging for the grantor to give him an option on the stock. If the grantor provides bona fide consideration, he will have an interest in the corporation like any other shareholder and is not likely to be controlled by the optionholder.⁷¹

By focusing on the means by which the grantor acquired his stock, the proposed rules make it possible to isolate those options that are being used to avoid the personal holding company tax.⁷²

⁷⁰ Another rule might be added, based on a presumption of control arising out of a certain relationship between the grantor and the grantee of an option. For example, an employer/grantee could be presumed to control the stock of an employee/grantor. This presumption is used in I.R.C. § 1563. See note 101 *infra*. Such a rule is unnecessary. If the option is not caught by Rules 1 and 2, it is probably not being used to avoid statutory ownership tests. Furthermore, in the employment relationship, the grantee is not likely to benefit from stock held by an employee to the same degree as from stock attributed to him by the other attribution rules.

⁷¹ The presence of adequate consideration is not relevant under Rule 1 because the direct sale of stock from the grantee to the optionholder raises the presumption that the option is being used to avoid the personal holding company tax.

⁷² Rules 1 and 2 differ greatly from the ABA proposal. See ABA Proposed Attribution Rules, *supra* note 4. The ABA proposal focuses on the imminence of the exercise of the option, and is concerned with whether the optionholder has a "significant present interest in the stock in question." *Id.* at 934. The proposal looks to certain objective criteria, such as the exercise date and price to determine whether a present interest exists. By focusing on the uncertainty of exercise, the ABA proposal fails to consider the reason for option attribution. As demonstrated by the discussion of those provisions where there is no option attribution, *see text and notes at notes 19-45 supra*, an optionholder is not considered to have a present interest in

Attribution rules are necessary to meet the strong incentive to avoid the punitive personal holding company provisions and the relative ease with which options can be used to evade the 50% ownership test. These factors, not present in the nonpunitive provisions previously examined, such as Subchapter S,⁷³ warrant a departure from the rule that an optionholder is not to be treated as a shareholder.⁷⁴ The suggested rules⁷⁵ are preferable to the current provision in that they reach situations where abuse is likely but do not affect option transactions not motivated by a desire to avoid the personal holding company provisions.⁷⁶

B. Section 318 and Stock Redemptions

Section 318⁷⁷ provides a set of attribution rules that operates only in conjunction with other specified sections of the Code.⁷⁸ Section 318's option attribution rule⁷⁹ is identical to the rule governing the personal holding company provisions⁸⁰ in treating the optionholder as the owner of the underlying stock. The purpose of section 318 is to provide certainty in determining stock ownership for corporate distributions and adjustments.⁸¹ Presumably,⁸² Congress perceived possibilities for abuse similar to those that prompted the option attribution rule for personal holding companies; a party

the underlying stock. Option attribution does not imply that the rights of an optionholder are equivalent to those of an actual stockholder. Rather, option attribution is imposed to prevent taxpayers from using options to avoid the consequences attaching to stock ownership. By focusing on the certainty of exercise and ignoring the reason for option attribution, the ABA proposal will not result in option attribution in those situations where it is appropriate.

⁷³ See text and notes at notes 33-45 *supra*.

⁷⁴ See text and notes at notes 19-45 *supra*.

⁷⁵ Rules 1 and 2 are not intended to affect I.R.C. § 544(a)(6). For a discussion of that section, see note 67 *supra*. Because the rules attribute stock ownership where the optionholder has significant control over the underlying stock, the first link in a double attribution chain remains solid. Since the first link of the attribution treats option ownership as equivalent to actual ownership, it is not objectionable to reattribute such stock.

⁷⁶ The stock ownership rules of I.R.C. § 544 are also used in I.R.C. § 341(d) and Treas. Reg. § 1.1551-1(e)(2) (1955).

⁷⁷ I.R.C. § 318.

⁷⁸ I.R.C. § 318's rules are used in conjunction with I.R.C. §§ 302, 304, 306(b)(1)(A), 334(b)(3)(c), 382(a)(3), 856(d), 958(b), 1239, 6038(d)(1).

⁷⁹ I.R.C. § 318(a)(4).

⁸⁰ See text and notes at notes 53-65 *supra*.

⁸¹ H.R. REP. NO. 1337, 83d Cong., 2d Sess. (1959), reprinted in [1954] U.S. CODE CONG. & AD. NEWS 4025, 4234.

⁸² Unfortunately, the Senate, which added the option attribution provision to the House bill during the 1954 revisions of the Internal Revenue Code, did not explain its action. S. REP. NO. 1662, 83d Cong., 2d Sess. (1954), reprinted in [1954] U.S. CODE CONG. & AD. NEWS 4621, 4890-92.

could avoid the tax consequences of stock ownership by using options to disperse his holdings.

The success of the section 318 option attribution rule can be analyzed by examining the rule as applied to the stock redemption provisions,⁸³ one of the principal areas in which section 318 operates. To qualify for the favorable tax treatment provided by section 302,⁸⁴ a stockholder whose shares are redeemed must incur a reduction in his proportionate interest in the corporation. This requirement reduces the risk that a stock redemption will provide a means to obtain capital gain treatment for a distribution that is in fact a dividend.⁸⁵ Congress formulated the redemption provisions to provide precise rules for determining whether a redemption is to be taxed as a dividend or at capital gains rates.⁸⁶ The gain on a redemption is to be taxed at capital gains rates if the redemption is substantially disproportionate⁸⁷ or if the shareholder completely terminates his interest in the corporation.⁸⁸

The determination whether a redemption is substantially disproportionate or results in a complete termination turns on stock ownership, both actual and constructive. The option attribution rule operates with the complete termination provision to deny capital gain treatment to a shareholder who retains any options after the redemption.⁸⁹ In combination with the "substantially disproportionate" provision, the option attribution rule can deny a shareholder capital gain treatment if the stocks underlying a retained

⁸³ I.R.C. §§ 302, 304, 306.

⁸⁴ I.R.C. § 302. Other redemptions covered by special statutory provisions are redemptions through the use of related corporations, I.R.C. § 304, and redemptions of § 306 stock. I.R.C. § 306. The analysis used for § 302 redemptions applies to § 304 or § 306 redemptions as well.

⁸⁵ For fuller explanation of how stock redemptions can be abused, see Wolfberg, *Stock Redemptions under Section 302 of the 1954 Code*, 48 TAXES 27, 28 (1970).

⁸⁶ H.R. REP. No. 1337, 83d Cong., 2d Sess. (1954), reprinted in [1954] U.S. CODE CONG. & AD. NEWS 4025, 4234.

⁸⁷ I.R.C. § 302(b)(2). For a definition of "substantially disproportionate," see note 90 *infra*.

⁸⁸ I.R.C. § 302(b)(3). A third type of redemption entitled to capital gain treatment is a redemption which, in the language of I.R.C. § 302(b)(1), "is not essentially equivalent to a dividend." The constructive ownership rules of I.R.C. § 318, although not directly used for an I.R.C. § 302(b)(1) redemption, are to be considered in evaluating the nature of the redemption. Treas. Reg. § 1.302-2(b) (1955); see *United States v. Davis*, 397 U.S. 301 (1970); *Haft Trust v. Commissioner*, 510 F.2d 43, 46 (1st Cir. 1975).

⁸⁹ In order to qualify under the complete termination provision, the taxpayer may not directly or constructively own any stock after the redemption. The family attribution rules are not applied if the taxpayer has no interest in the corporation after the redemption, does not acquire any subsequent interest within ten years of the redemption, and files the prescribed forms. I.R.C. § 302(c)(2). However, the taxpayer cannot avoid the option attribution rules of I.R.C. § 318.

option cause him to fail the percentage tests defining "substantially disproportionate."⁹⁰

Section 318's option attribution rule is overbroad. As with the rules governing personal holding companies, unwary optionholders can accidentally and unnecessarily be subjected to the tax consequences of attributed ownership. For example, a shareholder-officer who receives stock options as part of his compensation package could fail the percentage tests for a substantially disproportionate redemption even though the granting of these options is in no way related to the redemption. Although some option attribution is necessary to prevent the abuse of stock redemptions, attribution should be confined to the optionholder who benefits from and is able to control the voting of the underlying stock. The principal abuses can be prevented by applying Rules 1 and 2 as formulated in the discussion of the personal holding company provisions.

An additional problem presented by stock redemptions creates the need for a third attribution rule. Section 302 requires a party to terminate part or all of his interest in a corporation in order to qualify for a more favorable tax treatment of the gain from the redemption. When a corporation redeems the shares of a stockholder who retains an option and this optionholder subsequently exercises it, at least an appearance of a continuing interest in the corporation is present. The party seemingly has not reduced his interest to the extent of the shares received upon that exercise of the option. A third rule resolves this problem:

(Rule 3) An optionholder will be treated as owning the stock underlying the option if the option is exercised within five years after the date of redemption.⁹¹

⁹⁰ A taxpayer must meet three tests to qualify under the substantially disproportionate redemption provision. First, I.R.C. § 302(b)(2)(B) requires that after the redemption the shareholder must own less than 50% of the total combined voting power of all classes of outstanding stock entitled to vote. Second, I.R.C. § 302(b)(2)(C) requires that the shareholder's percentage of outstanding voting stock immediately after the redemption must be less than 80% of his ownership of such stock before the redemption. Finally, I.R.C. § 302(b)(2)(C) requires that the shareholder's percentage of outstanding common stock (whether voting or nonvoting) after the redemption be less than 80% of his ownership before the redemption.

⁹¹ Procedurally, this rule operates like the ten-year bar on stock acquisitions under the provisions allowing a waiver of family attribution rules in complete termination redemptions. I.R.C. § 302(c)(2)(A)(ii). See note 89 *supra*. Applied in the present context, I.R.C. § 302(c)(2)(A)(iii) would require the optionholder whose shares are redeemed to file a statement with the Commissioner agreeing to notify the Commissioner if any options are exercised within the proscribed time period, and to keep records of the transaction. The statute of limitations would be extended so that if the options are exercised within five years, an adjustment could be made to the tax due for the year of the redemption.

This rule in effect applies the step-transaction doctrine to options exercised subsequent to redemptions. The rule is unnecessary for the personal holding company provisions, which require annual determinations of a corporation's status.⁹² By contrast, a stock redemption is a single, isolated transaction. The transaction-oriented redemption provisions may tempt a party to manipulate his stock ownership at the time of the transaction to obtain more favorable tax treatment if he is able to return to the status quo after the transaction is complete. Personal holding companies do not present the same incentive for manipulation because it is impractical to set up an artificial situation year after year.⁹³ Rule 3 operates to prevent such temporary manipulations. If the shareholder is required to maintain the ownership arrangements existing at the time of the transaction for five years, the incentive for manipulation is greatly reduced.⁹⁴ The three rules together eliminate the opportunities for using options to abuse the transaction-oriented stock redemption provisions, while avoiding the broad sweep of the current rules.

C. Section 1563 and Multiple Corporations

Sections 1561 and 1563 were enacted to limit the tax advantages available to a group of shareholders who split their one corporation into several. Because certain tax benefits are extended on a per corporation basis,⁹⁵ without these sections shareholders could divide their business into several corporations to obtain multiple benefits.⁹⁶ Section 1561 removes this advantage of multiple corporations where the same shareholders own the stock by denying multiple benefits for "controlled corporations."⁹⁷ Section 1563(a) defines

⁹² I.R.C. § 541.

⁹³ Manipulation may also be precluded by drafting a statute so as to penalize a taxpayer who meets the definitional requirements at any time during the taxable year. The personal holding company provisions partially adopt this approach. Under I.R.C. § 542(a)(2), a company satisfies the stock ownership test if "at any time during the last half of the taxable year" the 50% test is met.

⁹⁴ An example of such an approach already found in the tax law is the five-year active business requirement of I.R.C. § 355(a)(3).

⁹⁵ Examples include the surtax exemption, I.R.C. § 11(d), the credit for the accumulated earnings tax, I.R.C. § 535(c)(2)-(3), and the \$25,000 limitation amount for the investment credit. I.R.C. § 46(a)(3).

⁹⁶ H.R. REP. No. 749, 88th Cong., 1st Sess. (1963), *reprinted in* 1964-1 C.B. pt. 2, at 125, 240-241; S. REP. No. 830, 88th Cong., 2d Sess. (1964), *reprinted in* 1964-1 C.B. pt. 2, at 505, 652-53.

⁹⁷ I.R.C. § 1561 covers the surtax exemption, the accumulated earnings credit, and the limitation on the small business deduction of life insurance companies. The investment tax credit \$25,000 limitation is covered by I.R.C. § 46(a)(6). I.R.C. § 269 is also used to attack

a "controlled group" in terms of stock ownership:⁹⁸ if specified shareholders own given percentages of a corporation's stock, that corporation is deemed a member of a controlled group of corporations.

Section 1563's rules for constructive ownership⁹⁹ treat an optionholder as owning the underlying stock.¹⁰⁰ If, for example, A corporation owns 20% of B corporation stock and has an option to acquire the other 80%, B is considered wholly owned by A and consequently not entitled to its own set of tax benefits.¹⁰¹ Without

multiple corporations. See *Your Host, Inc. v. Commissioner*, 489 F.2d 957 (2d Cir. 1973), cert. denied, 419 U.S. 829 (1974); *Napsky v. Commissioner*, 371 F.2d 189 (7th Cir. 1966); *Made Rite Inv. Co. v. Commissioner*, 357 F.2d 647 (9th Cir. 1966).

Section 1563's attribution rule might appear inconsistent with the treatment of options in the consolidated return context, where option attribution is not required. I.R.C. § 1561, like the consolidated returns provisions, is intended to assure that a single enterprise be taxed as a single enterprise. For a discussion of the purpose of I.R.C. § 1561, see *Fairfax Auto Parts Inc. v. Commissioner*, 65 T.C. 798, 803 (1976). If options do not give the holder a sufficient interest in the corporation to allow the filing of consolidated returns, then holding options should not be sufficient to invoke the enterprise theory of § 1561. The difference in treatment is required because, unlike the consolidated return provisions, § 1561 is punitive. The incentive for using options as a tax avoidance mechanism is thus greater under § 1561.

⁹⁸ I.R.C. § 1563(a)(1) defines a parent-subsidiary controlled group as one or more chains of corporations connected with a common parent corporation through 80% or more in stock ownership. A brother-sister controlled group, as defined by I.R.C. § 1563(a)(2), is one involving two or more corporations, if five or fewer persons or individuals, estates, or trusts own 80% of each corporation and such ownership is essentially pro rata, i.e., more than 50% of the stock of each corporation is owned by persons having identical interests in the corporation. For a general discussion of these definitions, see Shapiro, *New Multiple Corporation Surtax Exemption Rules*, 29 N.Y.U. INST. ON FED. TAX. 567 (1971).

⁹⁹ I.R.C. § 1563(e).

¹⁰⁰ I.R.C. § 1563(e)(1). The language used is identical to that used in I.R.C. §§ 318(a)(4) & 544(a)(3). I.R.C. § 1563(f)(3)(B) provides that the constructive ownership rules operate only where their effect is to make the corporation a controlled corporation. Thus the grantor of an option, rather than the grantee, will be regarded as the owner of the stock if the grantor satisfies the definitional requirements of I.R.C. § 1563. *Northwestern Steel & Supply Co. v. Commissioner*, 60 T.C. 356 (1973); *North American Indus. v. Commissioner*, 33 T.C.M. (CCH) 1275 (1974).

¹⁰¹ Options are also relevant to I.R.C. § 1563 through the concept of excluded stock, i.e., stock excluded from the denominator in calculating the percentage of ownership. I.R.C. §§ 1563(c)(2)(A)(iii), (B)(ii) provide that stock owned by an employee is excluded if the stock is subject to conditions that run in favor of the parent (for parent-subsidiary controlled groups) or in favor of common owners (for brother-sister controlled groups). In order for the stock to be excluded, the employee must be restricted in his right to dispose of it. Courts have held that stock owned by an employee subject to a 30-day option granted to a corporation, controlled by the parent corporation, to purchase the stock upon the death or termination of employment is to be treated as excluded stock. See, e.g., *Mid-America Indus., Inc. v. United States*, 477 F.2d 1029 (8th Cir. 1973); *Crow-Burlingame Co. v. Commissioner*, 65 T.C. 785 (1976). The regular option attribution rule is not applicable because the grantee is a corporation formed for the parent or common owner by a friendly third party, rather than the parent or common owner itself. For example, the grantee in *Mid-America Industries* was a corporation formed and owned by the parent's attorneys and accountant.

this rule, options would provide obvious possibilities for circumventing the controlled corporation provisions. A shareholder could transfer stock subject to an option to a friendly outside party to avoid section 1563's ownership tests, while retaining control over the stock. However, section 1563(e)(1),¹⁰² providing for option attribution, is unnecessarily broad. The potential abuses can be remedied without requiring attribution of the underlying stock for all options. Rules 1 and 2 are sufficient to prevent the use of options to avoid classification as a controlled corporation. Under the rules, options are attributed only when it is likely that the optionholder exercises control over the grantor and thus over the stock that the grantor owns. Abuses of sections 1561 and 1563 through the use of options are unlikely to occur without the element of control; option attribution should not extend beyond this point.¹⁰³

IV. INADEQUATE ATTRIBUTION TO THE OPTIONHOLDER

A. Excess Business Holdings Tax

Section 4943 of the Internal Revenue Code imposes a penalty tax on the excess business holdings of private foundations. Excess business holdings are defined as those holdings in a business enterprise that a private foundation must dispose of in order for the remaining holdings in the enterprise to be considered permitted holdings.¹⁰⁴ A private foundation is permitted to hold 20% of a corporation's voting stock; the 20% limitation is reduced by the percentage of voting stock owned by disqualified persons.¹⁰⁵ The definition of disqualified person encompasses those likely to have significant control over the foundation's operations, such as substantial contributors and foundation managers.¹⁰⁶ Section 4943 imposes an initial tax of 5% of the value of the excess holdings¹⁰⁷ and an additional tax

¹⁰² I.R.C. § 1563(e)(1).

¹⁰³ The status-oriented controlled corporation provisions do not require the application of the transaction-oriented Rule 3.

¹⁰⁴ I.R.C. § 4943(c)(1).

¹⁰⁵ I.R.C. § 4943(c)(2). Under I.R.C. § 4943(c)(2)(B), a private foundation may own up to 35% of the voting stock if individuals who are not disqualified persons can be shown to effectively control the corporation.

¹⁰⁶ The definition of disqualified person includes not only substantial contributors, I.R.C. § 4946(a)(1)(A), and foundation managers, I.R.C. § 4946(a)(1)(B), but also those who have a 20% ownership interest in an entity (*i.e.*, a corporation, partnership, trust, or unincorporated enterprise) which is a substantial contributor. I.R.C. § 4946(a)(1)(C). Such a party will be referred to as a 20% owner. The definition also encompasses family members of substantial contributors, foundation managers, and 20% owners, I.R.C. § 4946(a)(1)(D), and entities in which the persons listed above have a 35% interest. I.R.C. §§ 4946(a)(1)(E)-(G). Finally, certain related foundations are disqualified persons. I.R.C. § 4946(a)(1)(H).

¹⁰⁷ I.R.C. § 4943(a)(1).

equal to 200% of the excess holdings if they are not eliminated by the close of the correction period.¹⁰⁸

The excess business holdings tax was enacted as part of the Tax Reform Act of 1969¹⁰⁹ to meet concerns about the use of foundations to maintain control of family corporations. Congress believed that the managers of foundations that owned a significant interest in a corporation would divert their attention to the business and away from their charitable duties. Even if the charitable purpose dominated, the business could be run so as to compete unfairly with other businesses whose owners pay taxes on the income from the enterprise.¹¹⁰ Section 4943 provides for a confiscatory tax designed as a strong incentive for foundations to reduce their business holdings to the permitted level.¹¹¹

Because the tax is a direct penalty on stock ownership, attribution rules are especially important. Section 4943(d)(1) provides that in determining the business holdings of a private foundation or a disqualified person, any stock owned directly or indirectly by or for a corporation, partnership, estate, or trust is to be considered proportionately owned by its shareholders, partners, or beneficiaries. The section's provision for family attribution includes attribution from members of the families of substantial contributors or foundation managers.¹¹² Options are expressly treated in proposed regulations providing that a person holding an option to acquire stock is not considered the owner of the stock until the option is exercised.¹¹³ This proposed regulation is consistent with statements in the legislative history that the conversion features of convertible bonds and

¹⁰⁸ I.R.C. § 4943(b). The correction period is defined by I.R.C. § 4943(d)(3) as the period ending 90 days after the mailing of a notice of deficiency with respect to the 5% tax, or 90 days after the conclusion of litigation over the liability, or within such further period as may be granted for orderly disposition of the excess holdings. See generally Bumpas, *Section 4943: An Overview*, 27 TAX LAW. 263 (1973); Kauder, *Excess and Permitted Holding of Private Foundations: A Critique of the Treasury's Construction of Section 4943*, 30 TAX L. REV. 101 (1974); Plumb, *Avoiding the 200% Tax on Excess Holdings for 20 to 50% Owned Private Foundations*, 34 J. TAX. 296 (1971).

¹⁰⁹ Pub. L. No. 91-172, tit. I, § 101(b), 83 Stat. 507.

¹¹⁰ H.R. REP. NO. 413, 91st Cong., 1st Sess. 27 (1969); S. REP. NO. 552, 91st Cong., 1st Sess. 39 (1969).

¹¹¹ Congress expected that the 200% tax would lead the foundations to voluntary compliance and that the tax itself would rarely be imposed. S. REP. NO. 552, 91st Cong., 1st Sess. 33 (1969).

Stock held at the time the law was enacted is covered by I.R.C. § 4943(c)(4), which allows gradual disposition of excess holdings and prescribes different percentages of ownership as constituting excess business holdings. Special provisions also allow gradual disposition of excess holdings acquired by gift or bequest. See I.R.C. § 4943(c)(5)-(6).

¹¹² I.R.C. § 4946(a)(1)(D).

¹¹³ Prop. Reg. § 53.4943-7(a).

other securities are not to be considered voting stock.¹¹⁴

Although the absence of option attribution is supported by the legislative history, it opens the door for tax avoidance. Foundations and disqualified persons can place their shares with friendly outside parties, subject to an option to repurchase. Such arrangements are similar to those that appeared immediately after the enactment of the personal holding company provisions, prompting Congress to enact the Code's first option attribution rules.¹¹⁵ Option attribution is necessary to meet the substantial incentive to avoid the punitive excess business holdings tax. Rules 1 and 2 answer this need by attributing stock ownership to the option holder when it is reasonable to assume that the option is part of a tax-avoidance scheme.¹¹⁶ Rule 3 is not necessary in this context. The excess business holdings tax is not triggered by any specific transaction or date, but is incurred whenever the foundation's holdings exceed the permissible level.¹¹⁷ There is no incentive to use options to create a temporary artificial situation that would require the invocation of Rule 3.

B. Section 267

Section 267(a)(1) disallows deductions for losses on the sale or exchange of property between related parties. For example, no deduction is allowed for a loss realized in a sale between a corporation and an individual who directly or indirectly owns more than 50% of the value of its outstanding stock.¹¹⁸ Section 267(c) provides yet another set of rules outlining when a party will be regarded as owning stock.¹¹⁹ These rules are similar to those in sections 318,¹²⁰ 544,¹²¹

¹¹⁴ S. REP. NO. 552, 91st Cong., 1st Sess. 42 (1969). This provision also serves to solve a possible double counting problem. Double counting would occur if a substantial contributor grants an option to the foundation and the shares were treated as owned by the foundation and by the substantial contributor in determining whether the 20% ownership test was met. The regulation is one way of prohibiting double inclusion of the same shares. See Bumpas, *supra* note 108.

¹¹⁵ See text and notes at notes 57-62 *supra*.

¹¹⁶ See text and notes at notes 70-75 *supra*.

¹¹⁷ I.R.C. § 4943(a)(1).

¹¹⁸ I.R.C. § 267(b)(2). In addition to I.R.C. § 267(b)(2), two other provisions of § 267 involve stock ownership. I.R.C. § 267(b)(3) provides that losses on sales between two corporations will not be recognized if more than 50% of the stock of each is owned directly or indirectly by the same individual or if either corporation is a personal holding company or a foreign personal holding company. I.R.C. § 267(b)(8) precludes loss recognition on a sale between a fiduciary of a trust and corporation more than 50% of whose stock is owned directly or indirectly by or for the trust or by or for a person who is the grantor of the trust.

¹¹⁹ I.R.C. § 267(c). These attribution rules are also used in several other sections of the Code, e.g., I.R.C. §§ 178, 179, 341, 1235.

¹²⁰ I.R.C. § 318.

¹²¹ I.R.C. § 544.

and 1563¹²² covering the constructive ownership of stock by various family members, partners, and interested entities. Section 267 does not, however, include an option attribution rule.

The status of option attribution under section 267 is uncertain. In *Moore v. Commissioner*,¹²³ the only decision with even tangential relevance, the Fifth Circuit held that an individual with a binding contract to purchase stock owns the stock for the purposes of section 267. The court therefore disallowed the loss on the sale of an asset from the taxpayer to the corporation whose stock he had contracted to buy. The significant difference between a binding contract and an option diminishes the relevance of *Moore*. An optionholder incurs no liability in refusing to exercise his option; a promisor to a contract is liable if he fails to perform. Thus *Moore* is not authority for treating an optionholder as the owner of the underlying shares.

Several commentators,¹²⁴ believing that optionholders are not to be treated as stockholders under section 267,¹²⁵ find that the section presents opportunities for tax avoidance through the use of options.¹²⁶ For example, an individual who holds an option to buy 50% of a corporation's stock might sell an asset to that corporation at a loss, then exercise his option. Section 267, first enacted in 1934, is intended to prevent transactions that occur solely to recognize a loss for tax purposes.¹²⁷ The theory underlying the section is that the seller of an asset must totally divest himself of any interest in the asset in order to recognize a loss realized on the sale. If the purchaser is a related party, it is questionable whether the seller has absolutely disposed of his interest. The seller may still be deriving benefits from and exercising control over the asset through the related party. Given these possibilities for tax abuse, Congress concluded that a sale to a related party is not a sufficient divestiture to justify loss recognition.

Section 267 already attributes stock ownership from family members, partners, and interested entities. The problem is how to

¹²² I.R.C. § 1563.

¹²³ *Prentiss D. Moore*, 17 T.C. 1030 (1951), *aff'd*, 202 F.2d 45 (5th Cir. 1953).

¹²⁴ Ricketts, *supra* note 68; Reilly, *supra* note 5, at 274; REICH, RELATED TAXPAYERS—LOSSES, EXPENSES, INTEREST (1975) (BNA Tax Management Portfolio No. 102).

¹²⁵ The most convincing argument supporting this interpretation of § 267 is that when Congress intends option attribution it says so explicitly, as in I.R.C. §§ 318, 544 & 1563. See also text and notes at notes 130-41 *infra*.

¹²⁶ Ricketts, *supra* note 68, at 26; Reilly, *supra* note 5, at 274; REICH, *supra* note 124, at 11.

¹²⁷ H.R. REP. NO. 704, 73d Cong., 2d Sess. (1934), reprinted in 1939-1 C.B. pt. 2, at 554; *Hearings on Revenue Revision of 1934 Before House Comm. on Ways and Means*, 73d Cong., 2d Sess. 134 (1934) (statement of R. Magill).

treat a sale by *T* to *X* corporation when *T* owns less than 50% of the value of *X*'s stock but has an option to purchase sufficient stock from *A* to put himself over the 50% level. Because section 267 is a punitive provision, the incentive for manipulating stock ownership through the use of options is significant. The section should be expanded to include attribution from options.¹²⁸ An option attribution provision should focus on the relationship between *T* and *A* and the means by which *A* acquired his stock. If *A* acquired his stock in a transaction in which *T* was a moving party, *A* may be a friendly party whom *T* is using to avoid the 50% ownership test. Rules 1 and 2 can prevent this abuse. Under these rules, *T* would be considered the owner of the stock *A* holds subject to *T*'s option, since *A* is presumably under *T*'s control. Even if *A* is not a friendly party under *T*'s control, *T* might sell the asset to *X* corporation and shortly thereafter exercise the option. In this situation, *T* never really lost control of the asset and the loss on the sale should not be recognized. Losses should be disallowed regardless of who the grantor of the option is, if the option is exercised within a specified period after the sale. Rule 3 can achieve this result.¹²⁹ Together, the three rules provide the option attribution provisions needed to prevent the circumvention of section 267.

The inadequacy of section 267's attribution rules is made even more apparent by recent amendments to section 1239.¹³⁰ Section 1239 provides that the gain on the sale or exchange of depreciable property between certain related parties is taxed as ordinary income rather than as capital gain.¹³¹ Related parties include an individual who owns 80% of the value of a corporation's stock and that corporation,¹³² and two or more corporations where one individual owns 80% of the value of each corporation's stock.¹³³

Section 1239 is intended to discourage taxpayers from stepping up the basis of property by selling it to a related party.¹³⁴ For exam-

¹²⁸ The absence of any option attribution rules for I.R.C. § 267 is not surprising. The section was enacted three years before option attribution first entered the tax law, and that entrance was initially confined to the personal holding company provisions. See text and notes at notes 57-62 *supra*. Although Congress has since expanded option attribution, it has failed to rectify the omission in § 267's constructive ownership rules.

¹²⁹ The language of Rule 3 must be modified slightly from its formulation for redemptions to be applicable to § 267. In this context, "within five years of the redemption" is changed to read "within five years after the date of the sale."

¹³⁰ Tax Reform Act of 1976, Pub. L. No. 94-455, § 2129, 90 Stat. 1922.

¹³¹ I.R.C. § 1239(a).

¹³² I.R.C. § 1239(b)(2).

¹³³ I.R.C. § 1239(b)(3).

¹³⁴ See *United States v. Parker*, 376 F.2d 402, 407 (5th Cir. 1967); *Mitchell v. Commissioner*, 300 F.2d 533, 536-37 (4th Cir. 1962).

ple, a corporation owning property with a low basis is not entitled to substantial depreciation deductions. Without section 1239, the corporation could sell the asset to its controlling shareholder and treat the gain as a capital gain. If the shareholder held the property in his trade or business or for the production of income, he would be entitled to depreciation deductions on the purchase price, *i.e.*, on the stepped-up basis.¹³⁵ Section 1239 creates a substantial disincentive for such transactions by requiring the seller to treat the gain on the sale as ordinary income rather than capital gain. The theory for penalizing such a transaction is the same theory underlying section 267: the transfer of ownership between related parties is not a sufficient divestiture of the seller's interest in the asset to entitle him to favorable tax treatment.

As originally enacted in 1951, section 1239 contained narrow attribution rules providing that an individual constructively owned the stock of his spouse, minor children, and minor grandchildren. Although a regulation¹³⁶ provided that stock ownership included beneficial as well as legal ownership, the courts refused to apply this rule.¹³⁷ In particular, the government's attempt to attribute stock ownership from options was rejected.¹³⁸

Faced with this judicial interpretation of section 1239, Congress realized that the narrow attribution rules impeded the section's effectiveness. The Tax Reform Act of 1976 amends section 1239 to make section 318's option attribution rules¹³⁹ applicable in determining stock ownership for the purposes of section 1239.¹⁴⁰ Congress's recognition of the need for option attribution rules for section

¹³⁵ The same benefit could be obtained in a sale from the shareholder to the corporation or in a sale from one related corporation to another.

¹³⁶ Treas. Reg. § 1.239-1 (1957).

¹³⁷ *E.g.*, *Rothenberg v. United States*, 350 F.2d 319 (10th Cir. 1965); *Mitchell v. Commissioner*, 300 F.2d 533 (4th Cir. 1962).

A convincing legislative history supports the courts. The predecessor of § 1239, as proposed by the House in 1951, contained several constructive ownership provisions. H.R. REP. NO. 586, 82d Cong., 1st Sess. (1951), *reprinted in* [1951] U.S. CODE CONG. & ADM. NEWS 1781, 1807. In particular, stock owned by a corporation, partnership, estate, or trust was treated as proportionately owned by its stockholders, partners, or beneficiaries. The Senate felt that the House provisions were overbroad and would catch many nonabusive transactions. S. REP. NO. 781, 82d Cong., 1st Sess. (1951), *reprinted in* [1951] U.S. CODE CONG. & ADM. NEWS 1969, 2041. The law as finally enacted reflected the Senate's view. H.R. REP. NO. 1213, 82d Cong., 1st Sess. (1951), *reprinted in* [1951] U.S. CODE CONG. & ADM. NEWS 2121, 2135. It thus seems clear that Congress did not intend broad constructive ownership provisions to be used in § 1239.

¹³⁸ *Trotz v. Commissioner*, 361 F.2d 927 (10th Cir. 1966).

¹³⁹ S. REP. NO. 938, 94th Cong., 2d Sess. pt. 2, at 31 (1976).

¹⁴⁰ I.R.C. § 1239(c).

1239 makes the absence of such rules in section 267 even less justifiable. Both sections are premised on the same theory; both require option attribution to prevent taxpayers from using options to avoid the express statutory provisions.¹⁴¹

CONCLUSION

The need for attribution of stock ownership from stock options is a function of the likelihood that the parties will use options to avoid the consequences attached to stock ownership. Those sections of the Code that are punitive or transaction oriented create the greatest incentive for manipulation of stock ownership and thus require option attribution. When attribution is needed, it should be tailored to the purposes of the substantive tax provisions. Option attribution rules should be sufficiently broad to prevent tax avoidance, but sufficiently narrow to avoid encompassing arrangements not motivated by a desire to manipulate stock ownership.

The option attribution rules proposed in this comment attempt to delineate the appropriate scope of attribution in those sections where attribution is appropriate. The first two rules limit option attribution to those situations where an optionholder's presumed control over the grantor makes manipulation likely. The third rule, by attributing ownership when an option is exercised within a specified time period, bars a party from using stock options to manipulate stock ownership at the time of a transaction. The proposed rules may still be over- or underinclusive, but they are significantly more precise than current law.

Gary J. Winston

¹⁴¹ The changes in I.R.C. § 1239 were a response to judicial decisions adverse to the Commissioner on the issue of stock ownership. *See* notes 137-38 *supra*. By contrast, I.R.C. § 267(c) has generated little controversial litigation in the past decade.

